Internal Revenue Service

# memorandum

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Brl:VLDraper

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to: Eugene J. Wien, Special Trial Attorney CC:MA

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [redacted] v. Commissioner
Docket No. [redacted]

This memorandum is in response to your memorandum dated September 23, 1989, requesting tax litigation advice on the issue stated below.

ISSUE

Whether certain railroad properties are "facilities" and are therefore "qualified leased properties" as defined in the safe harbor leasing provisions of I.R.C. § 168(f)(8) even though part of the properties were used prior to 1981. 0168-0505; 0168-0800.

CONCLUSION

The railroad properties at issue are not "facilities" for the purposes of the safe harbor leasing provisions. Moreover, assuming arguendo that they are "facilities," some of them were sufficiently operative to be considered placed in service more than three months before the execution of the lease. Consequently, at least some of the properties at issue are not recovery properties and are therefore not properties qualified for the safe harbor leasing provisions.

FACTS

In [redacted] of [redacted], [redacted] entered into safe harbor lease transactions with [redacted]. [redacted] is a for-profit entity incorporated in [redacted] to take over the railroad properties of [redacted] insolvent railroads. It operates a freight railroad in [redacted] states in the [redacted] and [redacted] and had sustained substantial net operating losses through [redacted].

In these transactions, [redacted] sold to [redacted] and leased back, for Federal income tax purposes, $[redacted] of capitalized construction and rehabilitation expenditures. The examiner found that the following projects did not qualify for the safe harbor

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lease provisions because significant parts of the projects, which [redacted] called "facilities," had been placed in service more than three months before the execution of the leases.

The projects at issue are:

[redacted] Project - [redacted] to [redacted]
(TC 08)
(TC 09)
[redacted]

(See the attached Appeals Transmittal Memorandum and Supporting Statement for detailed descriptions of these projects.)

Under [redacted]'s budget process, capital expenditures go through complex approval procedures. Each of the above projects was designed and approved as a single project. Each of the projects had one completion report. These reports specify a single placed in service date. This is because, under [redacted]'s regular accounting methods, only one placed in service date and one completion date are required to evaluate and account for the project expenditures. While only one placed in service date is required in a report, a project engineer will sometimes indicate the approximate placement in service dates for particular components of a project to provide additional information on the construction process. For example, while the [redacted] project contains only a single placed in service date, the [redacted] completion report notes that final trackwork was placed in service in [redacted] and that the "last major component" of this project was placed in service on [redacted]

Although [redacted] officially lists the placed in service dates of the above projects as of the time the safe harbor leases for each project were executed, significant parts of the projects were operating much earlier. For example, the [redacted] project involved installation of a two-way rail traffic signaling system in place of the preexisting one-way system, permitting retirement of some track lines and the use of remaining track and siding for simultaneous two-way traffic. When new signals, connections to [redacted], temporary wiring and necessary track work were completed in a segment, such segment would be "cut over", i.e., turned over by construction personnel to local crews for actual train operations. Out of a total of [redacted] segments, all but one were "cut over" and operating more than three months before the lease was executed. [redacted] were cut over in [redacted], [redacted] in [redacted] in [redacted] of [redacted] and only the last within [redacted] months of the date of the lease execution.

There was similar use of the rail classification yards. A rail classification yard functions to (1) disassemble incoming trains whose cars are bound for many different destinations, (2) sort the cars by destination, and (3) reassemble them into new appropriately routed trains. The [redacted] project consisted of a new rail classification yard, new track connections between the yard and two [redacted] lines and a traffic control system. [redacted] conducted some operations in the [redacted] as early as [redacted] although the yard was still under construction. The [redacted] was constructed in segments, and of [redacted] segment "cut over" dates, one was in [redacted], and one was well before three months prior to the lease execution.

The [redacted] project consisted of a consolidation and improvement of an existing yard. The yard was never taken out of service during the reconstruction program, and new and renovated equipment was used as soon as it was installed. All trackwork in the classification and departure yards was completed by [redacted], and the installation of automatic switching was completed in [redacted]. The [redacted] was an expansion, reconfiguration and rehabilitation of an existing yard. The project also involved construction of numerous track connections between the yard and main lines. The construction took place over a period of years beginning [redacted], and the yard was in continual operation throughout the period.

DISCUSSION

Section 48(b)(2) defines "new section 38 property" in a sale-leaseback as only that property originally placed in service by the lessee and sold and leased back by such lessee within three months after the date such property was originally placed in service.

The safe harbor leasing provisions of the Code were enacted in the Economic Recovery Tax Act of 1981. Only certain property may come within the safe harbor leasing rules.

Section 168(f)(8)(D) defined "qualified leased property" as:

> (1) . . . recovery property ---
> (I) which is new Section 38 property of the lessor, which is leased within 3 months after such property was placed in service, and which, if acquired by the lessee, would have been new Section 38 property of the lessee . . .

Section 168(c) defines recovery property as follows:

> Except as provided in subsection (e), the term "recovery property" means tangible property of a character subject to the allowance for depreciation --- (A) Used in a trade or business, or (B) held for the production of income.

Section 168(e)(1) states that the term "recovery property" does not include property placed in service by the taxpayer before January 1, 1981.

Other relevant exclusions of property from the "recovery propery" classification are those contained in the anti-churning rules of section 168(e)(4). The anti-churning rules pertaining to "section 1245 class property" provide as follows:

> (4) Certain Transactions in Property Placed in Service Before 1981--(A) Section 1245 Class Property--The term "recovery property" does not include Section 1245 class property acquired by the taxpayer after December 31, 1980, if--
>
> (i) the property was owned or used at any time during 1980 by the taxpayer or a related person,
>
> (ii) the property is acquired from a person who owned such property during 1980, and, as part of the transaction, the use of such property does not change,
>
> (iii) the taxpayer leases such property to a person (or a person related to such a person) who owned or used such property at any time during 1980, or
>
> (iv) the property is acquired in a transaction as part of which the user of such property does not change and the property is not recovery property in the hands of the person from which the property is so acquired by reason of clause (ii) or (iii).

> For purposes of this subparagraph and subparagraph (B), property shall not be treated as owned before it is placed in service. For purposes of this subparagraph, whether the user of property changes as part of a transaction shall be determined in accordance with regulations prescribed by the Secretary.

Temp. Treas. Reg. § 5c.168(f)(8)-6(b) states:

> (1) Qualified lease property is recovery property and is, except as noted in (2) below, new section 38 property of the lessor which is leased no later than 3 months after the date the property was placed in service and which, if acquired by the lessee, would have been new section 38 property of the lessee. . ..
>
> (2) Placed in service. (i) Property shall be considered as placed in service at the time the property is placed in a condition or state of readiness and availability for a specifically assigned function. If an entire facility is leased under one lease, property which is part of the facility will not be considered placed in service under this rule until the entire facility is placed in service.
>
> (ii) For purposes other than determining whether property is qualified leased property, property subject to a lease under section 168(f)(8) will be deemed to have been placed in service not earlier than the date such property is used under the lease.

We believe your question centers around the factual issue of whether the taxpayer's project was a "facility" as intended by Temp. Treas. Reg. § 5c.168(f)(8)-6(b)(2). Other than an example in a temporary regulation and four private letter rulings, there is no guidance as to the meaning of the term "facility." Nevertheless, we believe that the nature of the taxpayer's projects is such that they do not come within a reasonable interpretation of the concept of "facility."

In 1981, Congress introduced the safe harbor lease provisions into the Code to enable all taxpayers, including those in a loss situation, to benefit from the accelerated cost recovery and investment tax credit provisions of the Economic Recovery Tax Act of 1981. Senate Finance Committee Hearing, Treasury Statement by John E. Chapoton (December 10, 1981). In order for a transaction to come within the safe harbor lease rules, there were many requirements. Inter alia, the property had to be "qualified lease property." Section 168(f)(8)(D) defines "qualified leased property" as recovery property which is new section 38 property of the lessor, and which is leased within three months after such property was placed in service, and which, if acquired by the lessee, would have been new section 38 property of the lessee.

Section 168(c) provides that, except as provided in subsection (e), the term "recovery property" means tangible property of a character subject to the allowance for depreciation --- (A) used in a trade or business, or (B) held for the production of income. Section 168(e)(1) states that the term "recovery property" does not include property placed in service by the taxpayer before Janaury 1, 1981.

Temp. Treas. Reg. § 5c.168(f)(8)-6(b) provides two rules for determining when property is placed in service. The first rule looks to when the property is placed in a condition or state of readiness and availability for a specifically assigned function. Temp. Treas. Reg. § 5c.168(f)(8)-6(b)(2) provides an exception to the general rule and considers the placed in service date as that date when the entire facility is leased, provided this occurs within three months of the date the final phase of the facility is placed in service.

We believe that the "facility" provision of Temp. Treas. Reg. § 5c.168(f)(8)-6(b) allows property which was placed in service prior to three months before the execution of the safe harbor lease to be considered "qualified leased property" if it is part of a facility that was not placed in service prior to such time.[1] The regulation is silent, however, as to what is intended as a "facility."

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[1] There is nothing in the statutes, regulations or legislative history which would exclude from this interpretation property which, but for the facility rule, would be considered placed in service before 1981. Consequently we do not think it is significant that [redacted]'s projects were conceived and constructed prior to 1981.

Temp. Treas. Reg. § 5f.168(f)(8)-1, Question-13, indicates that a "facility" requires integrated operational components. The question provides that a manufacturing complex which consisted of three integrated operational components, each with a different class life midpoint, constituted an "entire facility" within the meaning of Temp. Treas. Reg. § 5c.168(f)(8)-6(b)(2). We believe that the language, "integrated operational components," conveys the concept of multiple units, all of which are required to produce the intended product or service of the "facility." Consequently, there would be no "facility" which included discrete parts which could independently carry out the intended function of the project. This interpretation is born out in the private letter rulings.

Four private letter rulings indirectly address the issue of "facility" and provide some additional guidance on the meaning of the term. Two of them address the concept of a facility as used in the temporary regulations in the context of a coal transshipment facility, one which occupied 70 acres, one 26 acres. LTR 83-22-094 (June 3, 1983) and LTR 83-22-095 (June 3, 1983) respectively. Both state that the temporary regulation was "drafted specifically to address the placed in service problems of large facilities with integrated operations (emphasis added)." Under this interpretation, each of the property components of the facility will not be deemed placed in service until the entire facility is ready to perform its specifically assigned function. Both rulings found that an operation which included ground storage and transshipment of coal was a "facility."

The coal arrived by railcars drawn by locomotives not owned by the facility. This locomotive positioned the coal-laden railcars on tracks around the perimeter constructed as part of the operation. Locomotives owned and operated by the facility positioned the railcars once they were disconnected from the original transporting locomotive. The facility then operates in three stages: the stackout system when the coal shipments are unloaded, segregated and stockpiled in a storage area in the center; the reclaim system by which the coal is removed from the storage piles, placed onto underground conveyors and transported to the pier for loading; and the pier conveyor system that loads the coal aboard waiting vessels. In both cases, testing of the facility was completed in December 1982, and the facilities would have been considered placed in service by then. No coal, however, had been shipped by this date. The sale and leaseback agreements were to be executed in 1983 within three months of the commissioning of the operations.

In these cases, the facility was planned for one operation, i.e., the transshipment of coal. The different components of the system, though able to function independently, had no value to the owners until the entire facility was completed. Each phase and operation was integrally geared to the transshipment of coal. While conceivably many parts of the facility could have functioned independently of the rest, e.g., the tracks and locomotives, they would not have been used for their designated purpose until the entire facility was complete.

LTR 83-15-011 (October 29, 1982) ruled that a coke oven battery was placed in service on the date all construction necessary to produce coke had been completed and the ovens were ready and available to produce coke even though basic construction consisting of a physical superstructure was completed earlier. The ruling concluded that the battery of ovens was placed in service on the date "all construction necessary to produce coke had been completed and the ovens were ready and available to produce coke."

LTR 82-44-116 (October 29, 1982) ruled that equipment and tooling installed for use in auto development and production were part of a "facility" under the temporary regulation. The project had three phases. The first phase included acquisition of the machinery, equipment and tooling prior to December 1981. The second phase involved testing of the initially certified parts, subassemblies and tooling and equipment and also involved training supervisors and line personnel. During this part, a limited number of automobiles were produced, most of which went for further analysis and testing, and for public relations and other marketing purposes. None of the cars produced in the second phase would ever be sold to the public. The third phase involved a "system fill", i.e., the placing of parts and subassemblies in progressive states of assembly. The ruling held that the whole facility was placed in service at the beginning of the system fill. A lease within three months of this time would fall under the safe harbor lease provisions.

In all of these examples, the view of the Service was that the facility was not placed in service until the facility was ready to carry out its intended function. Thus, the concept of "facility" appears to be connected with a "function." In [redacted] case, however, discrete parts of the projects at issue were carrying out the intended function of the overall project long before the entire projects were completed. In two cases, the projects never ceased operating in their intended function during the whole construction period.

In the TCS project, [redacted] of the "cut overs" were fully operational and carrying on the intended function more than three months prior to the lease execution. Some operations were conducted in the [redacted] as early as [redacted] even though the Yard was still being constructed, and two of the five "cut overs" were fully functioning in their intended purpose more than three months prior to the lease execution. The [redacted] never ceased operating in its intended function during the construction period and newly reconstructed parts were often integrated into normal operations as soon as they were installed. The situation was almost the same with the [redacted].

To place [redacted]'s projects in the same category as those addressed in the temporary regulation and rulings and argue that the projects were not completed for purposes of the placed in service requirement until the last parts of them were completed is to stretch the meaning of "facility" beyond its intended purpose and open the concept for taxpayer manipulation. We believe it is irrelevant that under [redacted]'s internal accounting systems, each project was accounted for as a unit. Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1969).[2]

As all parts of [redacted]'s projects are not considered part of a "facility" as intended by the regulation, those parts of the projects which were "placed in a condition or state of readiness and availability for a specifically designed function" more than three months prior to the lease execution date were placed in service on that date. Temp. Treas. Reg. § 5c.168(f)(8)-6(b)(2)(i); SMC Corporation v. United States, 675 F.2d 113 (6th Cir. 1982). Thus, the following projects or parts of projects were placed in service on the date they were placed in a condition or state of readiness and availability for a specifically designed function, irrespective of the "facility" rule: [redacted] of the "cut overs" in the [redacted] project; the [redacted] and [redacted] "cut overs" associated with this project; and discrete parts of the [redacted] and [redacted].

Those parts of [redacted]'s projects placed in service more than three months before the lease was executed are not "qualified lease properties" as provided for in Section 168(f)(8)(D). First, the parts placed in service before 1981 are not recovery properties. To be "qualified lease properties," the properites must be recovery properties. Section 168(f)(8)(D)(1).

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[2] We recognize, however, that this issue is entirely factual and it will be the responsibility of the trial attorneys to develop the case showing the ability of parts of the facility to operate independently of the completion of the project for the purpose which they are ultimately intended to operate.

Section 168(e)(1) states that the term "recovery property" does not include property placed in service by the taxpayer before January 1, 1981. Although these parts were not acquired by [redacted] until after [redacted], the provisions of section 168(e)(4)(ii), (iii) and (iv) preclude the properties from being recovery properties. The parts involved are section 1245 class property as defined in section 168(g)(3); [redacted] acquired them from a person who owned such properties during [redacted]; and [redacted] leased the property to a person who owned or used the property during [redacted]. The parts of the projects which would not qualify as recovery properties include [redacted] "cut overs" in the [redacted] project, parts of the [redacted] and [redacted] "cut over" associated with this project, and probably parts of the [redacted] and [redacted] projects.

Next, the properties placed in service by [redacted] in [redacted] but prior to three months before the safe harbor lease was executed are also not qualified lease properties because the lease was not executed within three months after the property was placed in service. Further, the properties, if acquired by [redacted] at the time of the lease execution, would not have been new section 38 property of [redacted] at that time. Section 168(f)(8)(D)(i)(I). Section 48(b)(2) limits the term "new section 38 property" in a sale-leaseback situation to when the lease is executed within three months of time the property is originally placed in service. [redacted]'s properties placed in service in [redacted] but more than three months before the lease execution include [redacted] "cut overs" of the [redacted] project, [redacted] "cut over" of the [redacted], and probably parts of the [redacted], [redacted].

As a result, only the properties placed in service within three months of the date of the execution of the lease are "qualified lease property" eligible for the benefits of the safe harbor leasing provisions.

Alternative Argument

Alternatively, if the court should find that the projects are "facilities" as that concept is intended in the regulations, then the Service should argue that the "facilities" were completed for purposes of Temp. Treas. Reg. § 5c.168(f)(8)-6(b)(2) when they were substantially able to carry on their intended functions and hence were placed in service at that time. A taxpayer is deemed to have put property in service in the year when it is "placed in a condition or state of readiness and availability for a specifically assigned function." Treas. Reg. § 1.46-3(d). In several cases, this occurred more than three months before the execution of the lease.

The court can determine whether the "facility" was in reality placed in service even though certain portions of the facility may not have been completed by applying a test of whether the facility is "sufficiently operative" to be deemed placed in service for purposes of Temp. Treas. Reg. § 5c.168(f)(8)-6(b)(2). Under this "sufficiently operative" analysis, any of the discrete parts of the facilities functioning independently of the rest to accomplish the intended purpose of the facility which are completed more than three months prior to the lease execution are not recovery property and are not qualified for the safe harbor leasing provisions.

Under this test, the [redacted] project would be deemed completed prior to three months before the lease execution as [redacted] of the lines were "cut over" and hence operating for their intended function at that time. In both the [redacted] and the [redacted] rehabilitations and renovations, the yards never ceased carrying on the intended functions. In these cases, the facilities were in a condition or state of readiness for a specifically assigned function more than three months before the lease was executed.

Application of the "sufficiently operative" test can prevent taxpayer abuse. Under the "facility" concept as argued by the taxpayer, the taxpayer is placed in a position to manipulate situations such as the projects at issue to benefit from the tax law where such benefit was not intended. Because parts of the projects were able to operate in their intended function long before the final completion of minor portions of the projects, the taxpayer could time its final completion date to maximize its tax benefits rather than being guided by the economics of the situation. Thus, the taxpayer could and perhaps did delay the completion of the final phase of the projects to fall within the period three months prior to the lease execution. In contrast, in the examples from the regulation and letter rulings, the taxpayers could not carry on the intended function of the facility until the whole project was completed. In these cases, the taxpayer would have suffered a real economic loss from any delay in the final completion of the project.

The courts are continually on guard against interpreting statutes in such a way as to allow taxpayer manipulation. Graham v. Commissioner, 822 F.2d 844 (9th Cir. 1987); Estate of Kappell v. Commissioner, 615 F.2d 91 (3d Cir. 1980); Estate of Kamborian v. Commissioner, 469 F.2d 219 (1st Cir. 1972). Among other dangers, when a statute or regulation is subject to taxpayer manipulation of the concept, there exists the potential for different tax treatment of similarly situated taxpayers.

CONCLUSION

The taxpayer's projects are not the type of undertaking which was contemplated in Temp. Treas. Reg. § 5c.168(f)(8)-6(b)(2)(i) by the term "facility." A "facility" would be an operation no component of which can function independently to provide the intended service of the operation or to produce the product. Alternatively, if the taxpayer's projects are "facilities," then the court should apply a standard of "sufficiently operative" to determine when the facility is placed in service.

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Attachment

Appeals Transmittal Memorandum and Supporting Statement